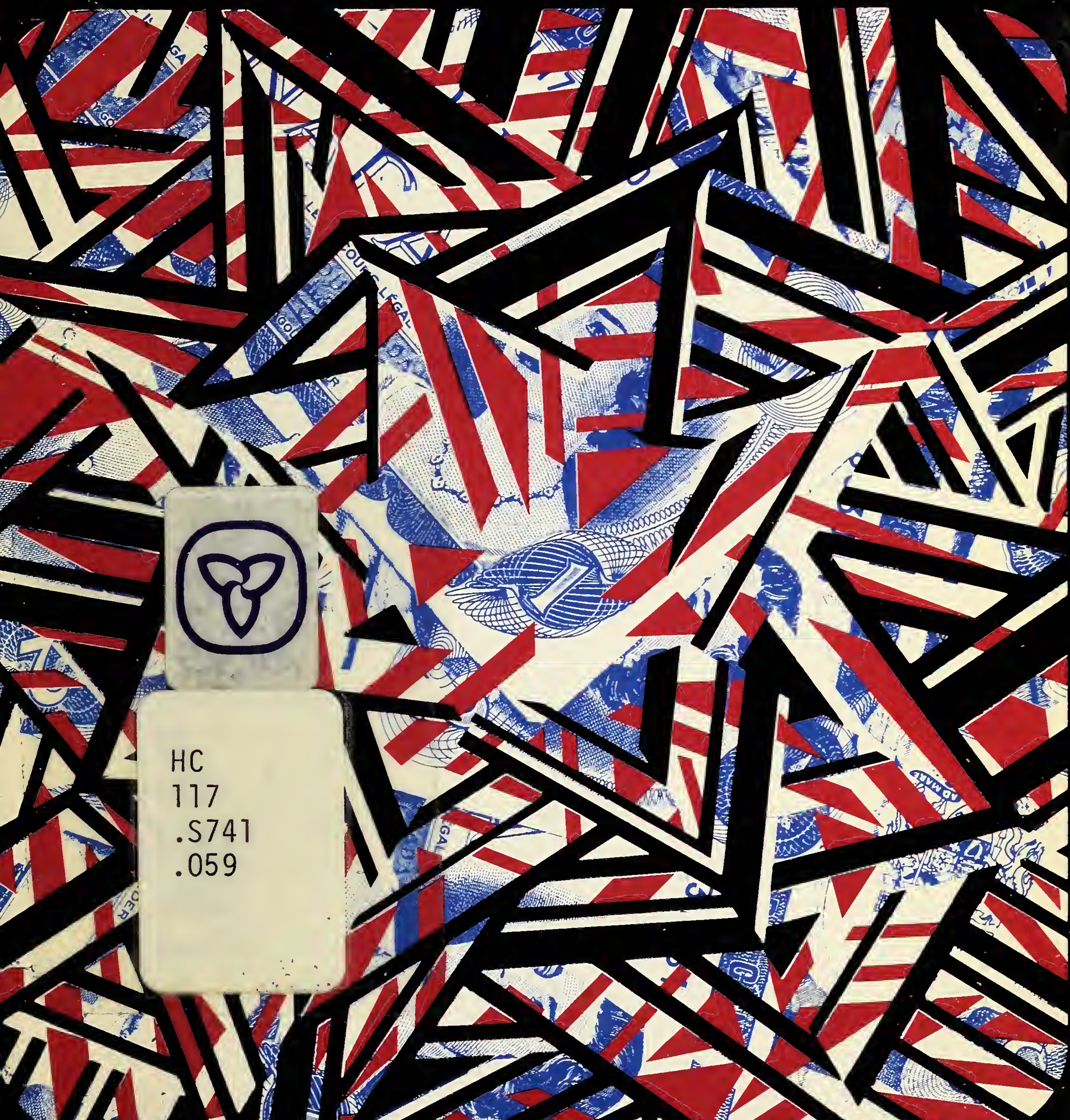
Inflation and the Taxation of Personal Investment Income:

An Ontario Economic Council Position Paper on the Canadian 1982 Reform Proposals



cdq, P

INFLATION AND THE TAXATION OF PERSONAL INVESTMENT INCOME: AN ONTARIO ECONOMIC COUNCIL POSITION PAPER ON THE CANADIAN 1982 REFORM PROPOSALS

ONTARIO ECONOMIC COUNCIL
SPECIAL RESEARCH REPORT

Ontario Economic Council
81 Wellesley Street East
Toronto, Ontario
M4Y 1H6

Printed in Canada

ISSN 0225-591X
ISBN 0-7743-7746-1

CONTENTS

MEMBERS OF THE ONTARIO ECONOMIC COUNCIL

Thomas J. Courchene, Chairman

Gerald R. Beaulieu
Administrator
Seafarers' Training Institute

† Jalynn H. Bennett
Assistant Vice-President
Manufacturers Life Insurance Company

W. Lyle Black
Medical Doctor
Greig Medical Group

Gail C.A. Cook
Executive Vice President
Bennecon Limited

††† E. Gerard Docquier
National Director
United Steelworkers of America

John Grant
Director and Chief Economist
Wood Gundy Limited

William A. Jones
Secretary-Treasurer
Ontario Teachers' Federation

Robert W. Korthals
President and Chief General Manager
Toronto Dominion Bank

William Mackness
Vice President & Economic Advisor
The Bank of Nova Scotia

†† Samuel A. Martin
Professor, School of Business Administration
University of Western Ontario

†† Elizabeth Parr-Johnston
Corporate Strategies
Shell Canada Limited

†† Clifford G. Pilkey
President
Ontario Federation of Labour

Bruno R. Rubess
President
Volkswagen Canada Inc.

†† Murray Rumack
Partner
Clarkson Gordon

David C. Smith
Deputy Chairman, Ontario Economic Council
Professor, Economics Department
Queen's University

Clayton M. Switzer
Dean of Agriculture
University of Guelph

Donald J. Taylor
Senior Vice President and Director
Shell Canada Limited

David M. Winch
Professor
Economics Department
McMaster University

† Since Jalynn H. Bennett is a member of the Lortie Committee assigned to evaluate formally the federal tax reform proposals, she did not participate in the preparation of this document.

†† Please refer to the appended comments by these Council members for a clarification of their positions with respect to this consensus document.

††† Mr. Docquier has only recently been appointed to the Council and he has not participated in the preparation of this document.

PREFACE

The Ontario Economic Council's mandate is to contribute to public awareness, discussion, and understanding of socio-economic issues that have special significance for the people of Ontario. The federal government's proposals for reforming the personal income tax system to take into account the impact of inflation on investment income are clearly measures that will have a dramatic impact on the lives of all Ontarians. Accordingly, the Ontario Economic Council is pleased to present to the people and government of Ontario its views on these proposals. Published simultaneously with this position paper is a more technical background document, "Inflation and the Taxation of Personal Investment Income": An Analysis and Evaluation of the Canadian 1982 Reform Proposals, which was commissioned by the Council in order to provide more detailed analysis and evaluation of the federal proposals. While this background document reflects the view of its authors, and not those of the Council, it did provide important input to the consensus document.

Needless to say, arriving at a consensus on as complicated an issue as major tax reform can be a difficult task, particularly since the Council is reasonably representative of the wide spectrum of interests that make up our province. Not every Council member is necessarily in favour of all the analyses and observations that follow. Indeed, some Council members have felt it necessary to dissent from, elaborate on, or highlight certain aspects of the consensus document. These comments are appended to the document.

As part of the consultative process associated with the federal proposals, the Minister of Finance constituted a "blue ribbon" Committee, chaired by Mr. Pierre Lortie, to evaluate these proposals. The deadline for submissions to the Committee was August 31, 1982. A pre-publication

draft of this document was fowarded to the Lortie Committee in accordance with the deadline.

Thomas J Courchene

T.J. Courchene
Chairman
Ontario Economic Council

INTRODUCTION

The Honourable Allan MacEachen's June 1982 Budget was accompanied by a White Paper, Inflation and the Taxation of Personal Investment Income. Subsequently, Mr. MacEachen appointed a committee (the "blue ribbon" committee headed by Mr. Pierre Lortie) to investigate the advisability of implementing the proposals contained in the White Paper. This committee was instructed to report to the Minister of Finance by the end of September 1982.

In the view of the Ontario Economic Council, the proposals set forth in the White Paper constitute one of the most fundamental reforms relating to the taxation of personal income in the post-war period. If implemented, these proposals would, in effect, alter the tax base for personal income, directly or indirectly affecting every Canadian citizen. Since the personal income tax base is shared between the federal and provincial governments, they would also have a significant influence on the budgetary position of the province of Ontario. This is in addition to the effect they would have in terms of extending federal regulation to areas of the financial institutional fabric that are presently under provincial jurisdiction. In short, the implementation of the White Paper's program would alter the existing economic and financial climate in ways that would have both immediate and long term implications for the province of Ontario.

Mr. MacEachen has invited Canadians to submit their views concerning the White Paper proposals. The Ontario Economic Council has responded to this invitation in two ways. First, we have commissioned three detailed studies on various aspects of the federal proposals. These studies, along with the comments of several discussants, appear as a Council background publication, "Inflation and the Taxation of Personal Investment Income": An Analysis and Evaluation of the Canadian 1982 Reform Proposals. This publication reflects the views of the authors and does not necessarily reflect

the views of the Ontario Economic Council. However, in view of the important nature of the question at issue, we have taken the further decision to issue the present Council Position Paper on Mr. MacEachen's proposals. Both initiatives are consistent with, if not motivated by, the Council's mandate to contribute to the understanding and discussion of socio-economic issues that have special significance for the people of Ontario.

Of course, the observations and recommendations that follow would be best assessed against the backdrop of the federal White Paper and the Council background study. Unfortunately, not all Ontarians will have had the opportunity to gain access to these publications. Thus, in order to make this Position Paper relatively self-contained, we begin by spelling out the key features of the federal proposals. Constraints of space and time are such that we cannot really do full justice here to the many ramifications and nuances associated with the specific recommendations. The interested reader is well advised to refer directly to the federal White Paper.

Following the brief description of the federal proposals, we shall address ourselves to some general observations relating to the proposals. The rest of the analysis focuses on three areas: 1) the philosophy underlying the proposed changes, 2) the specific changes recommended by the federal government, and 3) the modifications that the Council feels are required to the proposals as they now stand, assuming that some version of the plan is to be implemented. A short conclusion completes the position paper.

Not every member of the Council is necessarily in favour of all the analyses and the observations that follow.

2
AN OUTLINE OF THE FEDERAL PROPOSALS

Indexed Term Deposits and Loans

Under the federal government's proposals, a new type of debt instrument, the indexed term deposit (ITD), will be created. The yield from such deposits will be divided at year end into two components: a yield equal to the rate of inflation, which will not be taxed, and the remaining "real" yield, in excess of inflation, which will be taxed under the existing rate structure. These term deposits will flow through the financial institutions as a new type of indexed term loan (ITL) to borrowers who must be either purchasers of new homes or farmers, fishermen, or small businesses purchasing new depreciable property for use in Canada. The ITL's will also have a yield divided into two components: a yield equal to the rate of inflation and a real yield. In calculating their income tax, business borrowers will be able to deduct only the real interest cost of the ITL, not the inflation-indexed portion of the interest cost.

Other elements of this proposal include the following:

- Income reported from the ITD's will not be eligible for the $1,000 investment income deduction.

- Interest on funds borrowed to purchase an ITD will not be deductible in calculating income tax.

- Purchasers of ITD's must be individuals resident in Canada.

There are many basic questions about ITD's and ITL's that the proposals do not answer, including the following:

- If the real yield on ITD's is less than zero, will the negative real yield be deductible against other income in calculating income taxes?

- Will ITL's be transferable and/or renewable or will they have to be repaid upon sale of the related asset?

- If the supply of ITD's exceeds the demand for ITL's will rationing occur through yield adjustments in the market or through rationing of ITD's in accordance with future government directives?

- If an ITL is indexed using a general price index that exceeds the rate of increase in value of the related asset, how will the financial institution making the loan protect itself against default as its real security diminishes?

- Will the Consumer Price Index (CPI) be used for all indexation calculations?

Indexed Share Investments

A new type of investment program, called Registered Shareholder Investment Plan (RSIP's), will also be created. Individuals resident in Canada will be able to contribute to an RSIP through an investment dealer or other specified financial institution. The institution will purchase on the individual's behalf common shares of taxable Canadian corporations. At year-end, the institution will determine the market value of the shares and perform an indexing of the individual's contributions to the RSIP. The difference between the market value and the indexed value will be reported by the individual as a capital gain or capital loss each year for tax purposes. Other elements of the proposal include the following:

- The current system of taxing one-half of capital gains will continue, but one-half of all capital losses from the plan will be eligible as a deduction from the individual's income from any source in the year and will not be subject to the present $2,000 ceiling.

- Individuals will be required to include these capital gains and losses in their tax calculations each year, regardless of whether any disposals have actually occurred.

- Indexation will be calculated on the aggregate of all the investments in an RSIP.

3
GENERAL OBSERVATIONS

These proposals constitute a far-reaching reform of the taxation system with respect to borrowers and lenders. Before we enter upon more detailed analysis of the proposals several important underlying issues should be addressed.

First, the Council recognizes that Canada's fight against inflation has been very costly, particularly to certain sectors of the economy. Yet this fight must go on. Obviously, we are in favour of measures that will help Canadians cope with the burdens and uncertainties associated with the ongoing inflation. But the question that is of major concern to us is whether or not the White Paper propoals will make it easier or more difficult to bring inflation under better longer-run control. To the extent that the proposed measures would reduce the inequities and economic costs of disinflation, they carry the potential for easing the transition to lower inflation rates. However, to the extent that they would weaken the political will to resist inflation and add a source of instability to the economy's response to inflationary shocks, they would serve to direct attention away from the what we consider to be a paramount goal, namely, to eradicate inflation.

Observation I

Desirable as it may be to move in the direction of correcting for the inequities and efficiency costs rising from inflation, it is far more imperative that Canada not be diverted from reducing inflation and keeping it down.

The proposed reforms are not general in nature. On the lending

side, they are directed toward selected types of financial instruments and on the borrowing side they are aimed at specific categories of borrowers. As will be outlined in more detail later in the document, this would result in major windfall gains and losses to both individuals and whole sectors of the economy.

In the public's mind, these proposals have, until this point in time at any rate, been viewed as involving no "losers". This is simply not so. In particular, while the ITL program would favour the purchase of new homes and, therefore, the construction industry, it could result in substantial capital losses for existing homeowners. Moreover, it would provide no relief for homeowners seeking mortgage renewals because the latter would not be eligible under the proposed criteria. We do not deny that the proposals would correct one set of inequities and distortions. But just as surely they would introduce another.

Observation II

> The Council believes that, given their narrow design, the federal proposals would not guarantee a reduction in the overall inequities and distortions in the economy. What is clear, however, is that they would generate substantial new distortions and would, in an arbitrary fashion, create windfall gains and losses for some Canadians.

The Council recognizes that the recession has exacted a heavy toll from many individual Canadians as well as from whole sectors of the economy. We are not opposed to the federal government's providing some assistance to those individuals and sectors that currently find themselves in dire straits. What is of concern to us is that the proposed vehicle for providing such short-term assistance is a fundamental long-term change in the structure of taxation. It seems to us that there are a number of instruments in the policy arsenal that are better suited to providing cyclical assistance to those sectors in need. Some, indeed, are already being deployed.

Observation III

> The Council questions the wisdom of utilizing the vehicle of long

term structural change in the tax system for dealing with shorter-run cyclical problems.

The White Paper strongly hints that its proposals are to be the first step in the direction of a more comprehensive indexation of the taxation system for investment income. The Council respectfully asks: what are the next steps and when will they be instituted? How are Canadians supposed to evaluate the initial step of a major overhaul of the tax system when they are not provided with an overview of where the reform process is headed? This is a much more serious issue than it might at first appear. The tax system plays a critical role in the lives of all Canadians. We make decisions relating to spending, saving, investing, and provision for retirement in considerable measure on the basis of the features of the taxation system. To know that the federal proposal is only a first step but not to know when the promised further modifications will be undertaken or what they will entail must of necessity inject considerable uncertainty into the system.

Observation IV

Introducing a set of proposals designed as a first step without setting forth the intended subsequent steps and without providing a time-table for the overall reform process will generate increased uncertainty in the lives of Canadians. More uncertainty is precisely what we do not need.

Under the proposed programs as presently conceived, the federal government would be involved in a qualitatively new way in the allocation of credit in Canada. Two points are at issue here. In the first place, Ottawa proposed the designate who would and who would not be eligible to obtain the indexed term loans, raising the potential for substantial government control over the allocation of credit within the country. Second, the proposals raise a constitutional issue, since the proposal would, in effect, introduce federal regulation over some provincially chartered financial institutions.

Observation V

> The Council expresses concern over the potential in the proposals for substantial government intrusion in the operation of our financial institutions. Although it may not be the intention of these proposals to extend the role of government in allocating credit, the spectre of credit worthiness being determined on the basis of political rather than economic criteria is very disconcerting.

These, then, are some of the general observations we have relating to the federal proposal. The White Paper asks for the opinion of Canadians on various issues raised by the proposals. The first issue it requests response on is the following: "the desirability of providing selective correction for inflation in the tax system at the risk of introducing some new economic distortions into the system". (White Paper, p. 43)

Our views on this issue are rather evident from the above discussion. We have already focused on the "selective" character of the proposals and the likelihood that they would introduce "new economic distortions" and, hence, increased uncertainty.

Observation VI

> The Council cannot endorse the federal proposals as presently constituted. They are inferior to the two obvious alternatives (a) doing nothing and (b) modifying the proposals to make them more general and at the same time less distorting.

For some Council members, an outright rejection of the proposals is the preferred option. However, the majority of Council members believes that the underlying philosophy of indexing investment income should be incorporated into the tax system. Yet others take a more pragmatic position - given that the proposals are, in one form or another, likely to be implemented, it is desirable to design a modified set of proposals that will have a more beneficial impact on the economy.

The remainder of this Position Paper is devoted to a more detailed evaluation of the federal proposals with an eye to modifications that would make the reforms acceptable. (It should be emphasized that the various points touched upon in this analysis are all discussed more fully in the companion volume to the present paper, "Inflation and the Taxation of Personal Investment Income": An Analysis and Evaluation of the Canadian 1982 Reform Proposals, to which the reader is referred.)

4
INDEXING CAPITAL INCOME FOR INFLATION: SOME UNDERLYING PRINCIPLES

There are really two conceptually separate aspects to the federal proposals. One is the underlying principle that in an inflationary environment there are substantial negative implications for equity and allocative efficiency that attend a taxation system that is not indexed for personal investment income. The second relates to the specific federal proposal to introduce this long term reform in the personal income tax system in a manner which will aid the currently beleaguered sectors of the economy, namely housing, farmers, fishermen, and small businesses. In this section, we address the first of these. Is it in fact desirable to move toward a system of indexation of capital income?

Consequences of Non-Indexing

For Lenders

Consider the manner in which inflation affects the return on investment income. Assume first that there is no inflation and that an individual has a savings deposit of $1,000. At a real (that is, after inflation) interest rate of 2 per cent, his yearly interest income is $20. Suppose that the saver is in a 30 per cent tax bracket: his after-tax nominal interest income is $14 ($20 minus the tax of $6). Thus his nominal gain is $14. This is also his real gain, since we are in a zero-inflation world. As a percentage of his deposit, the after-tax real (and nominal) return is 1.4 per cent.

Now consider the same individual in a world in which inflation is proceeding at 10 per cent. Once again, we assume that the real interest rate is 2 per cent above the inflation rate, so that the interest on his savings deposit is 12 per cent. His nominal interest is $120 (12 per cent of $1,000). With a 30 per cent tax rate, his after-tax nominal interest

return is $84 ($120 less his tax of $36). However, in a world of 10 per cent inflation, the purchasing power of this $1,000 has diminished by $100. Thus the $84 of after-tax income is less than the fall in the real value of the deposit.

In other words, the real return is negative. Specifically, the individual has "lost" $16 in real terms, so that the after-tax real return on his investment is -1.6 per cent.

This result arises because, without indexation for investment income, the personal income tax system ends up taxing "illusory" gains. An appropriate taxation system would apply the tax rate only to the real portion (after-inflation portion) of any interest income. In the 10 per cent inflation case, this after-inflation portion would be $20, which is identical to the taxable amount in the scenario in which the inflation rate was zero. In other words, in order to ensure that the tax system is neutral with respect to investment income, it must be fully indexed with respect to inflation.

Much the same analysis applies to the return from equities. Taxes should be applied only to the real (after inflation) component of such returns.

This problem has, of course, been recognized in Canada in various ways. The $1,000 interest income exemption, the RRSP provision, and the taxation of only one-half of capital gains can all be rationalized as steps in the direction of offsetting the impact of inflation on the return on investment income, even though they may have been enacted for different reasons. The philosophy behind the present federal proposals is that it is now time to face the problem more directly and to introduce a rationalized approach to the problem by the indexation of investment income.

For Borrowers

The impact of non-indexing on borrowers is even more damaging, as the recent upsurge of bankruptcies has made painfully obvious. There are really two problems here. One relates to the very serious liquidity bind which borrowers, such as homeowners facing mortgage renewals, can get into when inflation accelerates. Because of inflation, the real value of a typical homeowner's outstanding mortgage has fallen while the real value of his home has remained the same (assuming that housing price increases

have matched those of prices generally). In this sense he is better off, since his net equity has increased. However, when the time comes for the homeowner to renew his mortgage, he finds himself called upon to make substantially higher cash payments under the terms of the new loan. In short, inflation has made him house-rich but liquidity-poor. Caught in this bind, some Canadians have had to forgo their homes.

One answer to this problem is an indexed mortgage - one in which the real value of yearly payments remains relatively constant over the term of the mortgage, rather than being tilted to be very high at the outset and to decline rapidly over the remaining term of the mortgage.

The second problem relates to the fact that the differential tax treatment of interest charges implies a very uneven pattern for after-tax real borrowing costs across sectors. We want to illustrate this by considering two types of borrowers. One type of borrower cannot deduct any interest payments for tax purposes. This corresponds to a homeowner as well as to a small or large business which has no taxable income against which to offset this borrowing cost. The other type of borrower is assumed to be a profit making corporation in the 50 per cent tax bracket. If both types of borrowers borrow funds at an interest rate of 18 per cent, the after-tax cost to the former, who cannot deduct interest costs is the full 18 per cent, whereas the after-tax cost to the latter is only 9 per cent. If the inflation rate is, say, 15 per cent, then the homeowner is saddled with a real interest cost of borrowing of 3 per cent, whereas the large corporation has an after-tax real borrowing cost of -6 per cent. Profitable corporations with a 25 per cent tax rate would fall between these two extremes.

Indexation would mean that all borrowers could deduct only the real interest portion of any borrowing cost, while the nominal interest portion would be offset by a corresponding appreciation in the asset (for homeowners) or by depreciation expenses calculated in terms of replacement costs (for firms).

These examples of the impact of inflation on borrowers and lenders are meant to be illustrative rather than exhaustive. Nonetheless, on the basis of this and other background evidence the Council has formed the following observations:

<u>Observation VII:</u> Indexing of investment income for inflation

is a desirable goal for the tax system for lender and borrower alike. If introduced in an appropriate fashion it is likely to result in efficiency gains in terms of resource allocation and it is likely to establish greater equity across the various sectors of the economy.

Observation VIII: While not all Council Members agree with the on-going thrust of monetary policy, we do agree that a system of inflation indexation for investment income would mean that the costs associated with the fight against inflation would be borne more equally across the various sectors of the economy - unlike the present situation, in which some sectors bear much heavier costs than others.

In general, therefore, the Council believes that inflation has combined with our existing tax structure to create inequities and inefficiencies that were never intended when the tax structure was implemented. The Council further believes that these inequities and inefficiencies are substantial enough to warrant modifications in the tax structure in the direction of indexing personal investment income for inflation.

At this juncture, it is important to recognize that when the federal proposals talk about "indexing" investment income they have two quite distinct things in mind. The first is the modification of the tax system to take account of inflation. The second is the introduction of financial instruments which are denominated in "real" terms (for example, the ITL's and ITD's). In everyday parlance, both these concepts can be captured by the term "indexing". However, it may be more instructive to refer to the former as the tax reform aspect of the proposals and the latter as the financial innovation aspect.

Observation IX

There are two components to the federal indexation proposals. The first is the tax treatment for inflation (tax reform). The second is the designation of indexed instruments (financial innovation) eligible for such tax treatment. The tax reform

component could be introduced without requiring that financial instruments be indexed. Likewise, financial instruments could be indexed (for example, indexed mortgages) without the tax reform aspect.

The federal proposal ties the two together. For example, to obtain the tax treatment for inflation, a saver must buy an indexed term deposit; that is, the new tax treatment for inflation will not be available for traditional deposits denominated in nominal terms. Is this twinning arrangement necessary? Assuming that it is desirable for instruments to be denominated in real terms, one answer might be "yes", since the private sector has not shown much interest in devising such deposits on its own. On the other hand, it is essential to note that under the current legal framework, there are some impediments to issuing indexed instruments. If tax reform is introduced, and the legal framework altered, what is the likelihood that the financial sector will introduce real or indexed financial instruments on its own initiative? If the financial institutions would not introduce such instruments on their own, is it wise to force such instruments on them? Putting the matter somewhat differently, there are costs and benefits to having the tax system indexed for inflation and there is a separate, but perhaps related, set of costs and benefits associated with the introduction of indexed financial instruments.

The Council has not had enough time to pursue this subject deeply. We restrict ourselves to the following observation:

Observation X

More time should be devoted to sorting out the costs and benefits of requiring that indexing the tax system for inflation must be tied to the issuance of indexed instruments.

Towards a General Approach to Indexing the Tax System for Inflation

The White Paper (pp. 13-14) describes the components of a comprehensive approach to adjusting the tax system for inflation for both investment and business income:

- for income from investments

  1. Restatement of interest income to exclude from taxable income an amount equal to the product of the principal amount of the debt and the rate of inflation.

  2. For borrowers, a corresponding exclusion from the amount of interest expense deductible in computing taxable income.

  3. For investment assets other than debt instruments, an increase in the cost base by the rate of inflation for the purpose of calculating capital gains.

- for business income

  1. The indexation of the undepreciated capital cost of properties (assets) by the rate of inflation.

  2. Restatement of cost of sales to reflect an inventory valuation adjustment equal to the product of the value of opening inventories and the rate of inflation.

  3. Restatement of interest expense to add to taxable income an amount equal to the product of the value of net debt and the rate of inflation.

Acknowledging that such adjustments would constitute a comprehensive indexation scheme, the White Paper proceeds to detail several reasons why such a comprehensive scheme cannot be implemented. Among the problems it enumerates are design complexities, tax revenue loss considerations, and international capital market implications. The Council does not minimize these problems. However, it makes the following observation:

Observation XI: In an ideal world, the desirable goal would

be to adopt this more comprehensive approach to adjusting taxable income for inflation. We recognize that there are some real-world problems that would make such a scheme difficult to attain in the present environment. Nonetheless, the principle of comprehensive indexation is an important benchmark by which to evaluate any specific proposals. In general, reforms to be preferred are those that move in this direction.

5
A MORE DETAILED EVALUATION OF THE FEDERAL PROPOSALS

Registered Shareholder Investment Plan (RSIP)

A skeleton outline of the federal proposals appeared above. Some features merit further elaboration. It is convenient to separate the federal proposals into two parts. One is the Registered Shareholder Investment Plan (RSIP) program. This is designed to encourage Canadians to acquire listed (on the stock exchanges) shares of corporations taxable in Canada. Under this plan, individuals would be liable for tax only on the portion of capital gains in _excess_ of the inflation rate (that is, only on real gains) and then only at one-half their marginal income tax rate. This would increase the after-tax yield on the shares of taxable Canadian corporations and thereby increase their prices. These price increases would reduce the cost of equity capital to the corporations. Given lower financing costs, capital expenditure for plants and equipment should be stimulated, with consequent increases in output and employment. Another feature of the RSIP program is that there would be an annual accounting of gains and/or losses on an accrual basis. The shares would be valued at the end of each year, and any gains above the rate of inflation would be subject to taxation in that year (with a reciprocal treatment for losses).

Indexed Term Deposits (ITD's) and Indexed Term Loans (ITL's)

Under this proposal, individuals would be granted access to Indexed Term Deposits (ITD's) issued by eligible financial intermediaries. These deposits will bear some _real_ interest rate, which in principle could be positive or negative. Suppose, for the purposes of illustration, that this real rate is 1 per cent. An individual investing in such an instrument

will, at the end of one year, receive an overall return which will equal the rate of inflation plus 1 per cent. He will pay tax on only the real portion, only the 1 per cent. Thus, on the one hand this is a fully indexed instrument, and on the other it is accorded tax treatment that incorporates inflation.

Research sponsored by the Council suggests that the supply of funds available to take advantage of this new debt instrument might be enormous. This is so because under present taxation practices many savers are required to live with negative real returns on debt instruments. For example, at a real rate of interest of +2 per cent, anywere from 20 to 70 billion dollars might find it profitable to move into ITD's. These figures may well be considerable overestimates, but for present purposes the key point is that the potential pool of funds that could take advantage of the new instruments is very large.

It is clear that ITD's would bear an overall rate of interest less than the concurrent interest rate on conventional term deposits. This lower rate would be passed through to selected borrowers of a corresponding ITL (Indexed Term Loan). Under the federal proposals, eligibility for ITL's would be restricted to purchasers of <u>new</u> homes and small businesses (including farmers and fishermen) requiring loans to finance purchases of <u>new</u> depreciable assets for use in Canada. Given these restrictions, the demand for ITL's - initially, at least - would be relatively small compared to the likely inflow of funds into ITD's, so that the market-clearing real interest rate on ITD's could well be negative.

This being the case, there would be a substantial reduction in the borrowing rates for mortgages for new houses and for loans for new capital purchases by small businesses. Let us focus just on the former. What it means is that <u>new</u> houses would be preferred to the <u>existing</u> stock. Indeed, the price wedge between the two (for identical houses) could be as large as 30 per cent. It is possible that this difference would be reflected entirely in an increase in the price of new houses. This is possible, but most unlikely, given the current state of the housing market. The more likely effect (certainly over the medium term, when the supply of new housing is more elastic) would be for the price of <u>existing houses to fall</u>*, creating substantial windfall gains and losses for new and

* This assumes that the privileged borrowing rate would "remain" with

old homeowners respectively. Two houses side by side, identical in all physical respects, would sell for very different prices if one was "new" and the other was not.

The Council is very concerned about this aspect of the federal proposal. We are acutely aware of the current sorry state of the economy and of the hardships faced by many Canadians, particularly by homeowners facing mortgage renewals. However, the federal government has not fully explained the implications of its proposal to Canadians. It is presently perceived as a program that involves no losers. This is not the case. Unless there are changes in the program (perhaps along the lines suggested below), this proposal has the potential for engineering rather substantial and arbitrary redistributions of wealth.

---

the new house forever, even if it was sold. If not, then the proposal would serve to "lock" the purchaser into his new house. New house prices would reflect the lower mortgage rate and the purchaser would suffer a corresponding capital loss if and when he attempted to resell it. Since, as will be noted below, one of the principal rationales for the ITD-ITL program relates to the stimulus it would provide to the construction sector, presumably the former assumption is the correct one. Under the latter, it is far from clear that the demand for new housing would increase.

6
SOME DESIRABLE MODIFICATIONS

We have addressed some of the undesirable features of the White Paper proposals. We shall now focus on those aspects which could be amended to make the proposals more acceptable. One conclusion received virtually unanimous support from the participants in the background study, namely that the eligibility conditions for borrowers of ITL's be broadened. The actual broadening need not take place immediately; what is required immediately is the knowledge that they will be broadened as of some fixed future date. For example, if it were known that on the renewal dates of their present mortgages, existing homeowners could also get access to ITL's, then the prospect of arbitrary redistribution and concern over government control of credit allocation would be minimized considerably. Moreover, if the list of eligible purposes to which these loans could be applied were broadened (for example, to include working capital as well as depreciable assets), this too would lessen any distortion implicit in the existing proposals.

> Observation XII: The eligibility criteria for the ITL program should be broadened considerably, with the eventual goal of greatly increased access both in terms of eligible borrowers and in terms of the uses to which the loans can be put.

Most of the other recommendations the Council has to make also have to do with ways in which the proposals could be broadened. For example, under the RSIP proposal, only shares of publicly listed corporations would qualify for indexation. This is too narrow: equity from all enterprises should be eligible to the extent that this is feasible. One stumbling block is the difficulty of devising a satisfactory method for capital gains taxation

on an accrual basis with respect to equity in companies whose shares are not traded. This could be solved in several ways, one of them being taxation on realization with some straightforward means of allocating and taxing any real gain over the holding period.

> Observation XIII: The criteria for instruments eligible to be included in an RSIP should be broadened.

The Council was struck by the lack of any reference in the proposals to the possibility that the federal government might issue indexed bonds. This would seem to be a natural starting point for moving toward a tax system indexed for investment income. Several other countries offer such instruments. From the federal government's standpoint, this approach would have the added advantage of reducing its deficit, since the overall cost of borrowing in this form would fall relative to the current rates on, say, Canada Savings Bonds.

> Observation XIV: The federal government should consider offering indexed bonds to the public, with only the real portion of interest payments being subject to taxation.

If Observation XIV is accepted, then XV follows:

> Observation XV: Provincial governments and their agencies should have the same privileges with respect to indexed bonds as the federal government.

Broadening the federal proposal would also include allowing the financial intermediaries the maximum scope to tailor the new instruments to their needs and those of their customers, borrowers and lenders alike. Not all financial intermediaries operate in the same market. Some are more restricted by their charters than are others. Accordingly:

> Observation XVI: Financial intermediaries should be allowed the maximum scope possible for adjusting to the requirements of any proposals for indexation.

It should be noted that even complete broadening of the eligibilty criteria for the new investment-income instruments (ITD's, ITL's, RSIP's, and hopefully, indexed government bonds) would not guarantee equal effective accessibility to indexed financing across all sectors of the economy. As long as the taxation of business income retains its inflation-induced distortions, there is little likelihood that small or large corporations with taxable income will be willing to utilize the new instruments for financial capital expansion. Over time, this asymmetry could create a bias in Canadian investment patterns in favour of the housing (and perhaps government) sectors and against the private business sector.

This possibility was touched upon at the Council-sponsored conference, where it was suggested that firms be allowed to index capital cost allowances and inventory costs to the extent that such costs exceeded the depreciation of the firm's debt due to inflation. However, given the complexity of the domestic and international behavioural issues involved, we have not had the time to arrive at a final conclusion regarding either the nature and potential seriousness of the problem itself or the desirability of particular offsetting tax changes. However, we do recognize that Canada and Ontario have enormous business investment needs over the next decade or two. This reinforces our point, made in Observation XI, that movement toward a comprehensive indexing system is desirable.

> Observation XVII: Broad-based indexation of the taxation of investment income, while desirable in itself, may have adverse long-term effects on capital expansion by private business unless accompanied by elimination of inflationary biases in the taxation of business income. Although the obstacles to such changes are considerable, the design of reasonable compromise measures may be feasible. The subject is worth serious detailed study.

Even if the federal government modified its proposals to make them agree with our recommendations to this point, there would still be a host of issues that needed sorting out. For example, there is the question of the manner in which the matching of ITL's and ITD's would take place, whether across firms, industries, or the entire financial sector. We have no particular expertise on this and certain other matters and, where we do

have it, the urgency with which this position paper has had to be drafted simply did not allow us sufficient time to come to a consensus. Many issues in addition to those discussed here are addressed in the Council study. There is, however, one additional suggestion in the companion volume that the Council wishes to endorse. This is the recommendation that an "indexation commission" be set up, composed of experts from various fields and free of political pressure. Issues such as what is the appropriate price index to use for purposes of indexation, how it should be altered over time to ensure that it is an adequate reflection of generalized purchasing power, what accounting practices will be acceptable and a myriad of other thorny problems that will undoubtedly arise are probably best handled by such a body.

> Observation XVIII: The Council recommends that an Indexation Commission or an Indexation Secretariat be instituted to deal with the many technical issues that will inevitably arise in connection with indexing investment income.

It has not escaped the Council that its suggested modifications would result in a more extensive and thorough-going reform than that outlined in the White Paper. These modifications are necessary if one wants to avoid the distortions, selectivity, uncertainty, and government control over the allocation of credit embodied in the federal proposals. On the other hand, such a thorough reform could be hard for the economy to swallow in one gulp.

Yet this consideration is no argument for taking a small and selective initial step, as the federal proposals imply it is. We feel that the preferred approach would be to go for a very broad program at the outset and, if it must be phased in, to do so in as nondiscriminatory a manner as possible.

For example, initial limits could be set as to the amounts of indexed instruments that any individual can hold (much like the limits on Canada Savings Bonds), and these limits could be gradually expanded over time. Or some initial limit could be applied to the maturity of these instruments (for example, at least five years to maturity) and over time these could be relaxed.

Alternatively, the tax treatment for inflation could be set at 6 per cent and 5 per cent for the next two years, consistent with the overall federal policy. A 6 per cent cap on tax treatment for the first year would probably mean that financial intermediaries would not have to offer indexed instruments with a negative real yield - a situation that they could find rather difficult to accept. This approach of broadening immediately with general limits retracted over time should allow the program to generate its positive effects on the economy with a minimum of new distortion and uncertainty:

> Observation XIX: If it is deemed desirable to introduce the program in phases, the preferable approach is to go for a very broad program with non-discriminatory caps or limits which will be relaxed over time.

Finally, we return to the issue of the sheer complexity of the proposed system. Major tax reform must be designed in such a way as to minimize the dislocation costs associated with its introduction and acceptance. This requires much in the way of background research and analysis. It would be much better, in our opinion, to take the appropriate time so as to ensure that this crucial background effort be well executed:

> Observation XX: The Council expresses concern over the undue haste which appears to attend the federal proposals.

7
CONCLUSIONS AND RECOMMENDATIONS

The federal proposals for indexing personal investment income issued with the June budget represent a fundamental reform of the personal income taxation system. The Council regrets that so little time has been allowed to evaluate their full implications. Within this limited time frame, we have set out above some of our observations pertaining to both the philosophy underlying and the details embodied in the federal proposals. We conclude by drawing some of these observations together in a series of recommendations.

- The Council endorses the principle that the indexation of investment income is a desirable feature of a taxation system.

- The Council feels that although the federal proposals, as presently constituted, do go some way toward this goal, the costs of the proposal in terms of new distortions, increased uncertainty, and futher regulation of the capital markets outweigh the benefits.

- An acceptable indexing scheme would be one that is much more general than the scheme embodied in the federal proposals. It would involve broadening the range of financial instruments eligible for indexed tax treatment, broadening the range of eligible borrowers, and broadening the range of uses to which borrowed funds could be put. Many of the negative features of the present set of proposals would be ameliorated under such a more general approach.

- If a phase-in period is required, the argument for phase-in should not be used to justify selectivity in scope and application. Rather, the preferred proposal should be broad and general at the outset,

with any phase-in features applied in as non-discriminatory a manner as possible.

- While the Council recognizes the desirability of altering the tax system to remove the allocative and equity problems that arise from inflation, we wish to underscore our first observation, namely that Canada not lose sight of the fact that eradicating inflation remains the first-best solution to these problems. Above all, the indexing proposal should not be such as to divert our policy makers from this important goal.

COMMENTARY
by Samuel A. Martin

The essence of the White Paper Proposals is that certain selected groups of Canadians would be singled out for "inflation-insulation" on a segment of their cash flows. Investors in indexed deposits would pay lower taxes on investment income; new home buyers, small businessmen, farmers and fishermen would pay lower interest rates on eligible term loans. The corollary, of course, is that the net gains, if any, made by these groups of Canadians would be shifted as costs to those groups unable or ineligible to participate.

I concur with the government's premise that inflation is devastating economic growth, stability, and equity. I also agree that some sectors of society are deserving of special consideration because of extraordinary economic hardship. And I do not seriously criticize the analysis in the Council's three commissioned papers or some observations in the Council document. (It is relevant to note, however, that despite the thoroughness of the analysis, one is left with a high degree of uncertainty as to the proposal's full implications - both macro and micro. In fact, the more one reflects, the more complicated the issue becomes.)

The White Paper proposes to address a fundamental, broadly based and chronic economic problem with a piecemeal, selective and diversionary solution. It is a program that is bewilderingly (indeed absurdly) complex, at a time when Canadians require clarity and focus.[1] Its concessions to

1 Roger Smith identifies 119 special and complex income tax concessions ("tax expenditures") for selected groups of Canadians valued at billions of dollars. Since these are not accounted for as cash expenditures, their magnitude, and their economic and social implications, are virtually impossible to measure.

special interest groups will sow the seeds of divisiveness and selfishness[2] when the country needs unity and co-operation. It is a further massive (and costly) intrusion by the government to challenge the natural market mechanisms which determine interest and inflation rates, at a time when our economic survival depends on less government insulation from the realities of vigorous, sustained competition.[3]

Inflation is one of Canada's fundamental financial problems. One of its causes is a widespread mentality of excess and delusion in financing both the public and private sectors. If it is in the national interest to subsidize the incomes of selected groups of Canadians, then parliament should legislate a program of expenditure targeted to those groups. Any such program of subsidy should show in advance how the expenditure is to be financed, and explicitly identify those groups of Canadians whose taxes will be increased (or incomes reduced) as a result of the subsidy. The ensuing debate would be enlightening for the country.

The Ontario Economic Council should withhold, unequivocally, endorsement of the MacEachen proposals. Indexing, regardless of modifications, attacks a symptom of inflation, not the disease. Instead let us urge the federal government to lead the assault on inflation itself by exercising fiscal integrity, and not accept palliatives designed simply to defer and deflect the adjustments all Canadians must make if we are to return to economic stability.

COMMENTARY
by Elizabeth Parr-Johnston

Fundamental to any response is the vivid realization that the federal government's proposals constitute fundamental tax reform and that in their present underdeveloped state they constitute the thin edge of a highly interventionist wedge. As constituted, I believe the proposals would be

2 The disparity in family disposable incomes in Canada already is among the highest in the world - the upper fifth of Canadian families have after tax incomes more than five times those of the lowest quintile.

3 Israel has had indexed investment instruments since 1955 when the inflation rate was seven per cent. Brazil introduced a form of indexation in 1964 to control hyper-inflation. In the month of March 1982 alone, consumer prices in both countries increased more than five percentage points.

highly detrimental to Ontario and to Canada since they constitute further distortions to already distorted capital markets.

My agreement with the Council's consensus document is predicated less on a belief in the validity of the economic rationale for indexing investment income than more pragmatically on the realization that the federal government is politically committed to taking some action - that the do-nothing option is unrealistic although preferable.

Broadly, I am concerned with the federal government's decision to focus on specific areas of investment income, making little attempt to link this to comprehensive indexation of corporate income taxes and ignoring the fact that personal income indexation is now capped. The result is that implementation of this type of proposal could shift the lion's share of the inflationary burden to the corporate sector with detrimental consequences for sorely needed corporate investment.

The remainder of this note deals with specifics on my continuing concerns with the consensus document:

Observation V

I strongly suspect that the federal government's intention in making these proposals is to extend the government's role in credit allocation. Indeed, I sense these propoals constitute a foot in the door which heralds the beginning of a fundamental change not only in the tax system but also in our financial institutions. Moreover, because the volume of funds potentially flowing through these indexed instruments is significant, access to these funds for purely political purposes could prove irresistible.

Observation VI

While I accept the proposition that indexing of investment income for inflation is a desirable goal for lender and borrower alike, I caution that indexing of investment income cannot be considered in isolation from the indexing of both personal and corporate income taxation.

Observation XI

I agree subject to the proviso that philosophically my preferred option is

no indexation, and caution that preferred reforms may not simply be a matter of degree since the instigation of reforms potentially opens the door to subsequent alterations and consequent investor uncertainties. Thus a preferred reform must be both comprehensive and "permanent", not subject to subsequent, frequent alterations.

Observation XII

In regard to the timing of the actual broadening, I question the efficacy of a policy which stages broadening, primarily because the Federal government has such a poor track record for keeping promises.

Observation XIII

I caution that, while desirable in theory, broadening of the criteria for instruments eligible for RSIP inclusion presents very real disclosure problems if extended to shares of unlisted corporations.

Observation XIX

I agree subject to my concerns voiced on Observation XII. The Federal government's track record is clearly on the side of reneging on promises.

ENDORSEMENT WITH RESERVATIONS
by Clifford G. Pilkey

While I agree with the general thrust of the Ontario Economic Council's critique of the federal budget discussion paper, Inflation and the Taxation of Personal Investment Income, I have reservations about some of its terminology, which reflects a philosophical position, held by some members of the Council, differing from that of the organization which I head.

Nevertheless, I endorse the document - albeit with reservations - because I believe it to be a useful addition to the debate and because labour, too, is critical of the federal government's approach to both inflation and taxation policies.

While the draft of the Council's statement quite correctly states, under the heading of general observations, that "Canada's fight against

inflation has been very costly, particularly to certain sectors of the economy", it goes on to say that "this fight must go on", implying that the Council agrees with the position that the harm done to the economy and the hardships imposed on the working people have been necessary, and that we only need more of the same to solve the problem of inflation.

As our economy is systematically and inexorably brought to a halt in the dubious battle against inflation, it becomes more and more apparent to more and more people that, as important as reducing inflation is, eradicating unemployment must be the number one and paramount goal of our society. While this is being written, even the premiers at the First Ministers' Conference in Halifax are finally, if haltingly, groping to that realization. Yet the Council's draft document does not acknowledge this reality of our slide toward economic disaster.

Nor do I believe that reference to "shorter-run cyclical problems" is a true description of the malaise that is affecting our economy. Surely with close to two million workers unemployed, with plants shutting down daily, and with business and farm bankruptcies increasing to epidemic proportions, it is time the Council recognized that our economy is in a full-scale recession, if not a depression.

I concur with the Council's view that it is difficult to support the reforms the federal government is proposing in its discussion paper when we are given no indication of what further changes in tax reform are envisioned, when they are likely to be made, and where this reform process is headed. These are very important questions, which, if answered, would make it easier for citizens to make decisions in regard to spending, saving, investing and providing for retirement income.

I would go further in criticizing the federal discussion paper in that I believe that correcting a single aspect of the tax system that affects only one sector of society is not likely to bring equity to the tax system. In my opinion, there must be a complete overhaul and restructuring of the tax system as proposed in the Carter Royal Commission Report on Taxation, a report that gave currency to the expression "a buck is a buck". Tinkering with one aspect of the system by selective correction for inflation will only create new economic distortions and further erode equity and fairness.

For example, while I can support the indexing of investment income, I believe that workers' income also should be indexed for inflation for tax

purposes. After all, what is good for those who work with capital should be good for those who create it.

I am more concerned with this than with what the Council document refers to as its concern that there is a potential in the federal proposals for substantial government intrusion in the operation of our financial institutions. The Council's fear of government intervention in the market place is an echo of those voices clamouring for deregulation of our social and economic life, while ignoring the fact that it was the abuses of the market place that compelled government to intrude in the first place - in order to protect the public interest. On balance I would support intervention.

COMMENTARY
by Murray Rumack

While I agree with the Council's observations, I wish to emphasize that the reform proposals constitute a major set of changes.

These proposals should not be regarded as a minor alteration of existing procedures. Substantial difficulties would accompany the practical implementation of the proposals.

In view of the importance of the proposals and the difficulties involved in implementing them, the federal government should slow down the reform process. The government is attempting to change too much too soon. At least two years should be set aside for the careful examination of these proposals prior to their implementation. A two year period is necessary in order to modify the proposals in the most appropriate manner and to ensure that their impact is fully understood.

Ontario Economic Council Papers

Special Research Reports

Energy Policies for the 1980s: an economic analysis

Developments Abroad and the Domestic Economy

Policies for Stagflation: Focus on Supply

Inflation and the Taxation of Personal Investment Income: an analysis and evaluation of the Canadian 1982 Reform Proposals

Inflation and the Taxation of Personal Investment Income: an Ontario Economic Council Position Paper on the Canadian 1982 Reform Proposals

Copies of these publications are available at a nominal charge from the Ontario Government Bookstore, 880 Bay Street, Toronto to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in northwestern Ontario, O-Zenith 67200).

ISSN 0225-591X

ISBN 0-7743-7746-1